Managing Relevant Change:
A Road Ahead for the Rural Banking Industry[1]

1. Introduction

The Honorable, Representative Nelson Collantes, PDIC EVP Mel Singzon, RBAP President Vitto Almario, distinguished RBAP Past Presidents, the officers and members of the Rural Bankers Association of the Philippines (RBAP), distinguished guests, our esteemed speakers, ladies and gentlemen, good morning.

Let me start by expressing our sympathy and our solidarity with our countrymen in Tacloban City, in other parts of Leyte, and in other badly affected areas in the path of Typhoon Yolanda who have all suffered horrific damage. I am sure there are rural bankers who are not able to join us here today as victims themselves and who need to attend first to their customers and their own employees and families. Our hearts go out to them. May they be safe and continue to have a resilient spirit to recover from all these.

We will need to do all we can to help them. There are many logistical difficulties but BSP will be working closely with our affected banks to help restore their operations at the soonest possible time so they can start serving again their customers especially with cash withdrawals now and later with loans to help them recover and rebuild. You can expect immediate deployment of our standard regulatory relief package designed precisely to help cope with calamities. But given the scale of recent devastation from the 1 - 2 punch of the Bohol earthquake and now Typhoon Yolanda, we will need to actively think of additional measures to bolster our support.

These are obviously not the best of times but I am nonetheless very pleased to join RBAP in its activities and today is not an exception. President Almario, holding your 56th Charter Anniversary Symposium is a milestone which deserves to be part of what is already a long and colorful history for RBAP. But to choose to re-assess and re-invent yourselves at this juncture – as your theme indicates – makes this two-day event all the more significant.

It would be natural to presume that the choice of your theme has to do with the time of the year. We are, after all, closing out this year and are about to begin a new operating year.

I suspect though that it is much more than that. Interacting regularly with the RBAP board throughout the year, I can see firsthand how conscious rural bankers are of their own operating environment.

As a community though, the main challenge is that the changing environment are not those peculiar to specific localities. What we see instead is a fundamental reshaping of the market landscape because of reforms designed globally as well as those initiated domestically.

[1] *Keynote Speech delivered by BSP Deputy Governor Nestor A. Espenilla, Jr. at the Rural Bankers Association of the Philippines' 56th Charter Anniversary Symposium held on 11 November 2013 at the Manila Hotel in Manila.*

We are therefore literally in the midst of a sea of change. With that in mind, allow me to focus my remarks this morning on what is driving the array of changes before us, why should we pursue these changes, which of these changes matter to rural banking, and where exactly are we heading.

2. The Need for Change

We are all familiar with what had transpired in the advanced markets.

Low interest rates persisted in the United States creating a mortgage boom. Financial engineering then took over and turned long-term illiquid mortgages into tradable mortgage backed securities (MBS) and into broader pools of asset backed securities (ABS).

This engineered string then morphed into Collateralized Mortgage Obligations (CMOs) and then more generally into Collateralized Debt Obligations (CDOs).

What was then simply a traditional loan became a web of instruments. From MBS, ABS, CMOs, and CDOs, this alphabet soup had its final ingredient in CDS (credit default swap) arrangements.

In Europe, economies collapsed under their own fiscal burden. Financial markets were strained in the attempt to address both liquidity and solvency challenges. Banks, even among the biggest in the world as it turned out, did not have as strong a balance sheet as they thought, creating a facet of stress that had not been seen before.

Everyone here today knows the story that follows. Global standard setting bodies crafted a reform agenda that was specifically meant to address the weaknesses that were already apparent.

Thus, you now hear of the work generated by the introduction of Basel 3, accounting standard amendments, compensation and governance reforms, financial market infrastructure guidelines, standardization of OTC derivatives, large exposure limits and more recently, financial market benchmark reforms.

The fair question to ask though is why any of these matter to us as a country and to rural banking in particular who have always been mostly engaged in basic but very real banking, of mobilizing deposits and giving out loans to real people .

After all, did we not have the difficulties that the advanced economies experienced? Were we not resilient to the global fallout that ensued? Did we not generate growth when most everyone else contracted?

3. Why These Matter to the Rural Banking Industry

The answers to these questions are all a resounding YES. In fact, when one looks at the review of 3rd party analysts such as credit rating agencies, the Philippine banking system has indeed been seen in a strong and positive light.

But if we are to limit ourselves to the headline indicators and pat ourselves for the positive reviews, we run the danger of missing the real lessons of the global crisis.

Yes, the US mortgage market may have been “over-engineered” beyond prudential norms. But it is not the expansion itself which was the issue. Rather, it was the fact that no one was monitoring the build-up of system-wide risks arising from transactions that appear sound on paper when taken individually.

A similar point can be argued for the public debt market in Europe. But it was not just an issue of uncontrolled leverage but the intersection of fiscal policy and capital markets. Government securities could simply not be issued to cover the debt hole since sovereign and debt premiums had also increased significantly.

In the end, the pricing of financial risks essentially broke down. There were risks that were recognized but remained unaccounted for (ie., re-securitization risks, liquidity risks under market stress etc) and there were risks that were simply unrecognized (ie., inter-connectedness)

This ability to reflect, mitigate and price risks is central to banking. And for this reason, the reforms are relevant to rural banks because the lessons from the crisis are what matters.

The concept of “inter-connectedness”, for example, should be familiar to rural banks. You know this first hand when there are banks in your area that face difficulties even if your own bank is otherwise healthy. The same context of inter-connectedness is evident when there is a system failure, for example when direct check clearing participants are not able to service indirect clearing participants.

Managing liquidity is certainly neither new nor trivial for rural bankers. The very nature of banking in the countryside requires a significant premium on cash flows and liquidity. Although capital adequacy remains our prudential benchmark, managing liquidity is often the first hurdle that must be met. A bank with a high capital adequacy ratio or CAR but is unable to service its cashflow obligations will find that it is liquidity, not solvency, that could break the bank.

That said, the need for stronger balance sheets is ultimately the issue. Financial markets are more open today and thus susceptible to external factors. With financial risks expanding and becoming more complex, the ability of rural banks to withstand stress scenarios is a continuing policy issue.

Such stress points could very well be generated within the bank itself or it may just as well be overall market conditions. What is important is that the bank has enough financial power to withstand these stress points even before the stress points become evident. That is clearly a capital issue.

Recognizing the pitfalls of inter-connectedness, the challenges of managing liquidity and the need for stronger balance sheets are among the key lessons from the crisis and are therefore part of the wherewithal for the reform agenda.

We are not talking about setting the same bar for universal and rural banks, for example. Instead, we believe that a more nuanced and calibrated approach is warranted. Just as our universal and commercial banks and their subsidiaries are about to go into a Basel 3 framework in January, we introduced and phased in our own Basel 1.5 for RBs back in 2011. Such calibrations are not a compromise of governance standards. Rather, it is the flexibility needed so that we avoid handling differentiated concerns with the same absolute approach. While the goal of strengthening banks is the same, the approach cannot be one size fits all

4. Re-inventing Rural Banking: Key Challenges Ahead

Given all of these, how then can the rural banking industry meet your own theme at this symposium, that is, to make the industry more relevant to its stakeholders.

From our perspective, you may want to highlight six key facets.

First, the industry cannot and should not waver in its core mandate of being an intrinsic element of rural development.

Rural banks are in the best position to drive rural development. This is not just a funding issue but your presence in rural neighborhoods affords you the distinct advantage of being part of the very same market. As we have said in the past, you live where you work and are therefore your own stakeholder. That is unique. That is precious.

Banking for your community is not a "last mile' initiative but often the first steps for those venturing into the financial market. This makes you natural agents of financial inclusion. With a population closing in on 100 million spread over an archipelago where only 20 percent of households have bank accounts, the task of covering the unbanked and underbanked is undoubtedly a big challenge.

Second, rural banks need to better appreciate that the principles of risk management are not anchored on the size of the balance sheet.

Whether we are talking about universal banks that operate across a multitude of business lines or the simpler operations of rural banks, the credit risks faced by the former is the same credit risk faced by the latter. We understand and appreciate the personal relationships that are embedded in rural banking but these relationships do not alter the type of risks that banks in general face.

Perhaps the specific presentation of the risks may vary in rural banking context but the substance of financial risks is not altered by balance sheet size. What is at issue is the ability of bank management to identify, mitigate and manage risks given that these risks cannot be diversified out of the balance sheet.

For this reason, a better understanding of the various risks is essential for bank management. We recognize this and this is why we have invested significant resources to design, put together and mount a strategic 4-day course for rural bank management. After the 3rd and final run, we shall turn this over on turnkey basis to RBAP. I trust that you will continue to run the program as long as rural bankers need it.

Third, banking has gone well beyond its beginnings on benches in Italy. Today, there is a substantial technological component that is involved and I would expect our rural banks to continue to find ways to benefit from such technologies.

This issue is relevant in several aspects, from the submission by RBs of their financial statements, to streamlining their back office support operations, to exploiting commercial opportunities in the market. Without a robust system backing operations, rural banks will always be hard pressed to be at the frontier of effectively serving their constituents and staying competitive.

Those constituents include the BSP where we need to understand each bank through its financials or identify the risk exposures being taken. We simply cannot do that unless we get timely and clean FRP submission which today remains a challenge.

On the other hand, new technologies especially affordable digital communications technology and social media offer our smaller banks new opportunities to operate more efficiently and to create innovative products. I would strongly encourage you to study carefully our new technology risk guidelines embodied in Circular 808. This opens the door to cloud computing and outsourcing arrangements that can make you operate potentially like the banks in many ways without the big outlays and the complexity and risk of managing IT migration projects. I note that your last session today is about a Uniform Core Banking System being lead advocated by PDIC on behalf of the Financial Sector Forum.

Fourth, equity, especially foreign equity from a well-selected strategic partner can be a lynchpin for a stronger and expanded balance sheet and for achieving sufficient scale of operations.

This is now made possible with the passage of Republic Act 10574. Yet, with the additional opportunities provided by law, these still need to be tapped and managed well.

For those who parlay foreign partnerships, these rural banks can now become larger players in the countryside. But with the larger balance sheet comes larger risk exposures. Handled pro-actively, this is an advantage.

But this is also where a fuller appreciation of the operating environment and the ensuing banking risks becomes critical. Banks simply do not operate on auto pilot mode. It needs explicit steering from bank management from the strategic choices that must be made. Thus, foreign capital is an opportunity but its value proposition will still depend on what bank management has in store for it.

Fifth, rural banks cannot overlook the needs of the financial consumer. This is particularly the case with the countryside where the triumvirate needs of financial inclusion, consumer protection and financial literacy are perhaps most apparent.

The very nature of rural banking puts a premium on personal relationships. This can only enhance the fiduciary responsibility of rural banks as you serve your stakeholders. But if rural development is the ultimate goal, nurturing the financial well-being of the banking public is central to achieving this policy objective.

Since your program allots a plenary session on consumer protection for tomorrow, let me not delve deeply into this topic. Suffice it to say that financial consumer protection is very important. Its importance is highlighted by the fact that standard-setting bodies have included consumer protection as an integral component of banking supervision.

Sixth, rural banks must continuously develop alliances and business partnerships, with other rural banks, with the bigger banks, with other financial institutions like insurance companies, and with other non-bank institutions like telcos and technology service providers. There is strength in forming robust eco-systems to deliver a broad array of world class quality financial services to your home markets.

Think insurance. The amended insurance code and our forthcoming enhance cross-selling guidelines will allow our rural banks to distribute more types of insurance products beyond micro-insurance.

Think electronic payments. Our ever liberalizing guidelines and our determined push to develop a shared electronic payments infrastructure open up opportunities for new types of remittance and payment products.

5. Final Thoughts

Ladies and gentlemen, we have covered a bit of ground this morning.

Amid the rapid changes in the global markets, rural banks must be able to evolve and adapt to ensure long-term sustainability. Since reinventing oneself is a deliberate process, we need to be very clear where we want to go moving forward.

Adherence to high standards of good governance is always a critical aspect if the industry is to reinvent itself. While this process of re-assessing and eventually re-inventing oneself is not unique, it must translate to better risk management execution on the part of banks.

This is true for any bank and rural banks cannot be an exception.

But risk management itself comes in different facets and different forms. This morning, I have specifically talked about the pitfalls of inter-connectedness, the challenges of managing liquidity, the need for stronger balance sheets, parlaying technological advances, identifying strategic partnerships, and protecting the interests of the financial consumer as among the critical issues facing rural banks.

Admittedly, that is quite an array of strategic issues. But perhaps, we must recognize that this is not a list from which we can choose what to pursue. Perhaps, the real challenge is in recognizing the value of each of these elements in a broader strategic plan.

The choice then is how to execute.

More than just your regulator, the BSP stands as your partner in this strategic journey. We recognize that it is a journey of many many steps but know also, know always that we are here by the side of RBAP every step of the way.

Thank you for your attention and may all of you have a meaningful symposium.

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